Simpson Thacher

Memorandum

IRS Releases Interim and Transition Rules Regarding the Calculation of Unrelated Business Taxable Income Under Code Section 512(a)(6)

August 28, 2018

On August 21, 2018, the Internal Revenue Service (the "Service") released Notice 2018-67, Request for Comments Regarding the Calculation of Unrelated Business Taxable Income Under §512(a)(6) for Exempt Organizations with More than One Unrelated Trade or Business; Interim and Transition Rules for Aggregating Certain Income in the Nature of Investments; and the Treatment of Global Intangible Low-Taxed Income Inclusions for Purposes of the Unrelated Business Income Tax (the "Notice").[1]

The Notice provides interim and transitional guidance regarding the calculation of unrelated business taxable income ("UBTI") under new section 512(a)(6) of the Internal Revenue Code of 1986, as amended (the "Code"). Code section 512(a)(6) was included as part of the comprehensive tax reform legislation signed into law on December 22, 2017 (the "Law")[2] and requires that a tax-exempt organization with more than one unrelated trade or business calculate UBTI separately with respect to each unrelated trade or business.

The Notice includes a general interim rule that provides a tax-exempt organization latitude to rely on a reasonable, good-faith interpretation of Code sections 511 through 514 when determining whether it has more than one unrelated trade or business for purposes of new Code section 512(a)(6).

The Notice also includes additional interim and transitional rules related to UBTI-generating partnership interests held for investment purposes. Under the interim rule, a tax-exempt organization may aggregate as

[1] The Notice is available here.

[2] Please see our summary of the provisions of the Law that affect tax-exempt organizations and donors to tax-exempt organizations, available here. For a more general summary of the Law's provisions, please see the memorandum of Simpson Thacher & Bartlett LLP's Tax Department, available here.

a single unrelated trade or business for purposes of new Code section 512(a)(6) the entire group of partnership interests held by the tax-exempt organization for investment purposes that satisfy either an ownership or a control test. Under the transition rule, a tax-exempt organization may treat as a single unrelated trade or business for purposes of new Code section 512(a)(6) any single partnership interest held by the tax-exempt organization as of the date of the Notice that does not meet either test. For both the interim rule and the transition rule, unrelated debt-financed income derived from the relevant partnership interests may be aggregated.

I. Background

Although generally not subject to tax, tax-exempt organizations are subject to tax on their UBTI, which is computed at regular corporate tax rates. The Law significantly changed the rules for calculating UBTI. In particular, new Code section 512(a)(6) requires that a tax-exempt organization with more than one unrelated trade or business calculate UBTI separately for each unrelated trade or business, and determine its overall UBTI based on the sum of UBTI computed with respect to each unrelated trade or business (which may not be less than zero), less a specific deduction under Code section 512(b)(12). Under prior law, a tax-exempt organization could aggregate income and deductions (including deductions for net operating losses) from its various unrelated trades or businesses, thereby allowing the tax-exempt organization to use a deduction from one unrelated trade or business to offset income from another, and hence reduce its UBTI. Under new Code section 512(a)(6), a tax-exempt organization no longer may apply a deduction from one unrelated trade or business to offset income from another, although it may use deductions from a specific unrelated trade or business activity accrued in one taxable year to offset income from the same unrelated trade or business activity in another taxable year, where appropriate. Under a transition rule included in the Law, a tax-exempt organization with existing net operating losses from its unrelated trade or business activity in taxable years prior to January 1, 2018 may carry forward those losses and use them to offset its UBTI in subsequent taxable years after it has otherwise calculated its UBTI in accordance with new Code section 512(a)(6).

Following the enactment of the Law, certain commentators urged the Service and the Department of the Treasury ("Treasury") to delay the implementation of Code section 512(a)(6) until the issuance of regulations. The Service and Treasury have not delayed implementation.

II. Interim and Transitional Guidance

A. Reasonable, Good-Faith Interpretation of Code sections 511 through 514

The computation rules of Code section 512(a)(6) apply only to a tax-exempt organization with more than one unrelated trade or business. Code section 512(a)(6) does not set forth criteria for determining whether a tax-exempt organization has more than one unrelated trade or business, or for distinguishing the separate unrelated trades or businesses of a tax-exempt organization.

The Notice indicates that the Service and Treasury intend to propose regulations for determining whether a tax-exempt organization has more than one unrelated trade or business for purposes of Code section 512(a)(6) and how to identify separate trades or businesses for purposes of calculating UBTI under Code section 512(a)(6).

Pending publication of proposed regulations, a general interim rule provides that a tax-exempt organization may rely on a reasonable, good-faith interpretation of Code sections 511 through 514, considering all the facts and circumstances, when determining whether it has more than one unrelated trade or business for purposes of Code section 512(a)(6). The Notice indicates that:

- A reasonable, good-faith interpretation includes using the North American Industry Classification System (NAICS) six-digit codes;[3]
- The fragmentation principle of Code section 513(c) and Treasury Regulation section 1.513-1(b) may provide useful guidance in identifying separate trades or businesses for purposes of Code section 512(a)(6);[4] and
- A reasonable, good-faith interpretation of Code sections 511 through 514 includes using a reasonable, good-faith interpretation when determining whether to separate debt-financed income, income from a controlled entity and insurance income earned through a controlled foreign corporation.[5]

B. Aggregation of Investment Activities

The Notice states that, as a matter of administrative convenience, the Service and Treasury intend to propose regulations treating certain investment activities of a tax-exempt organization as a single trade or business for purposes of Code section 512(a)(6) in order to permit a tax-exempt organization to aggregate gross income and directly related deductions from certain investment activities.

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3 The NAICS is an industry classification system. A tax-exempt organization required to file IRS Form 990-T, Exempt Organization Business Income Tax Return, is already required to describe its unrelated trades or businesses using the NAICS six-digit codes. Information about NAICS codes is available here.

4 The fragmentation principle provides generally that an activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of an organization.

5 These items of gross income would otherwise be excluded from the calculation of UBTI, but are treated as items of gross income derived from an unrelated trade or business under Code sections 512(b)(4), (13) and (17). Certain commentators have argued that these statutory inclusions should not be considered attributable to any unrelated trade or business for purposes of Code section 512(a)(6), since there is no nexus to an unrelated trade or business. The Notice indicates that the Service and Treasury generally do not see a distinction between these categories of UBTI and others, but acknowledge that certain interpretations of Code section 512(a)(6) could pose administrative burdens for a tax-exempt organization with debt-financed income, income from a controlled entity and insurance income earned through a controlled foreign corporation.

Pending publication of proposed regulations, the Notice sets forth an interim rule and a transition rule for aggregation of certain investment activities.[6]

1. Interim Rule for Aggregation

Under the interim rule, a tax-exempt organization may aggregate UBTI from its interest in a single partnership that has multiple trades or businesses, including trades or businesses conducted by lower-tier partnerships, as long as the tax-exempt organization's directly-held interest in the partnership is a "qualifying partnership interest" because it meets the requirements of <u>either</u> the *de minimis* test <u>or</u> the control test, each as described below. In addition, a tax-exempt organization may aggregate all qualifying partnership interests and treat the aggregate group of qualifying partnership interests as comprising a <u>single trade or business</u> for purposes of Code section 512(a)(6). Income permitted to be aggregated includes any unrelated debt-financed income that arises in connection with a qualifying partnership interest.

- <u>*De Minimis* Test</u>: Pursuant to the interim rule, a partnership interest is a qualifying partnership interest that meets the requirements of the *de minimis* test if the tax-exempt organization holds directly no more than 2 percent of the profits interest and no more than 2 percent of the capital interest.
    - A tax-exempt organization will be considered to hold no more than 2 percent of the profits or capital interests in a partnership if the average of the tax-exempt organization's percentage interest at the beginning and the end of the partnership's taxable year (or, in the case of a partnership interest held for less than a year, the percentage interest held at the beginning and end of the period of ownership within the partnership's taxable year) is no more than 2 percent, based on information received from the partnership on Schedule K-1.
    - In determining its percentage interest in a partnership for purposes of the *de minimis* test, a tax-exempt organization must include the percentage interests in the partnership held by any disqualified persons within the meaning of Code section 4958, supporting organizations within the meaning of Code section 509(a)(3) and controlled entities within the meaning of Code section 512(b)(13)(D).

- <u>Control Test</u>: Pursuant to the interim rule, a partnership interest is a qualifying partnership interest that meets the requirements of the control test if the tax-exempt organization (i) directly holds no more than 20 percent of the capital interest; <u>and</u> (ii) does not have control or influence over the partnership.

[6] Neither the interim rule nor the transition rule apply to social clubs exempt under Code section 501(c)(7) that are subject to Code section 512(a)(3).

- A tax-exempt organization will be considered to hold no more than 20 percent of the capital interest in a partnership if the average of the organization's percentage interest at the beginning and the end of the partnership's taxable year (or, in the case of a partnership interest held for less than a year, the percentage interest held at the beginning and end of the period of ownership within the partnership's taxable year) is no more than 20 percent, based on information received from the partnership on Schedule K-1.
- In determining its percentage interest in a partnership for purposes of the control test, a tax-exempt organization must include the percentage interests in the partnership held by any disqualified persons within the meaning of Code section 4958, supporting organizations within the meaning of Code section 509(a)(3) and controlled entities within the meaning of Code section 512(b)(13)(D).
- For purposes of determining whether a tax-exempt organization has control or influence over a partnership, all facts and circumstances are relevant. A tax-exempt organization has control or influence if (i) it may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership, (ii) any of its officers, directors, trustees, or employees have rights to participate in the management of the partnership or conduct the partnership's business at any time, or (iii) it has the power to appoint or remove any of the partnership's officers, directors, trustees, or employees.

2. Transition Rule for Aggregation

A tax-exempt organization may apply a transition rule to partnership interests acquired prior to August 21, 2018 that are not qualifying partnership interests. A tax-exempt organization may treat each such partnership interest as comprising a single trade or business for purposes of Code section 512(a)(6) whether or not there is more than one trade or business directly or indirectly conducted by the partnership or lower-tier partnerships. Income permitted to be aggregated includes any unrelated debt-financed income that arises in connection with a partnership interest with respect to which a tax-exempt organization applies the transition rule.

Unlike qualifying partnership interests under the interim rule, the Notice does not specify that a tax-exempt organization may aggregate all partnership interests to which it applies the transition rule and treat that aggregate group of partnership interests as comprising a single trade or business for purposes of § 512(a)(6). Likewise, the Notice does not indicate that a tax-exempt organization may aggregate partnership interests to which it applies the transition rule with qualifying partnerships aggregated under the interim rule.

Importantly, the Notice does not provide for aggregation of all partnership investment activities into a single unrelated trade or business for purposes of Code section 512(a)(6). For example, if a tax-exempt organization's investment portfolio includes multiple partnership interests that are not qualifying partnership interests and that generate UBTI, or qualifying partnership interests and at least one partnership interest that is not a qualifying partnership interest and that generates UBTI, the tax-exempt organization will have more than one unrelated trade or business for purposes of Code section 512(a)(6), unless they can otherwise be aggregated under the general interim rule for reasonable, good-faith interpretations of the applicable Code provisions.

C. Treatment of Fringe Benefits

In addition to the computation changes of Code section 512(a)(6), the Law added new Code section 512(a)(7), which increases a tax-exempt organization's UBTI by any amount paid or incurred for any qualified transportation fringe (as defined in Code section 132(f)), any parking facility used in connection with qualified parking (as defined in Code section 132(f)(5)(C)) and any on-premises athletic facility (as defined in Code section 132(j)(4)(B)), in each case, that is not directly connected to an unrelated trade or business that is regularly carried on by the tax-exempt organization and for which a deduction under Code section 274 is not allowable.

The Notice indicates that the Service and Treasury do not believe that the provision of the fringe benefits described in Code section 512(a)(7) is an unrelated trade or business. Accordingly, any amount included in UBTI under Code section 512(a)(7) is not subject to Code section 512(a)(6).

D. Treatment of GILTI

The Law also added new Code section 951A, which requires each U.S. shareholder of any controlled foreign corporation to include in gross income its global intangible low-taxed income (GILTI).

The Notice indicates that the Service and Treasury have determined that an inclusion of GILTI under Code section 951A(a) will be treated as a dividend that is generally excluded from UBTI under Code section 512(b)(1). The Notice further indicates that, unless provided otherwise in proposed regulations, GILTI that is included in gross income under Code section 951A(a) and attributable to insurance income will not be treated as includible in the UBTI of a tax-exempt organization.

E. Reliance

For taxable years beginning after December 31, 2017, tax-exempt organizations may rely on the provisions of the Notice until proposed regulations are published.

III. Requests for Comments

The Notice indicates that the Service and Treasury request comments regarding the matters addressed in the Notice.[7] We encourage tax-exempt organizations to share their views with the Service and Treasury. Comments in connection with the Notice must be received by December 3, 2018.

IV. Conclusion

We are available to discuss the Notice, as well as the Law and its impact, and we will continue to monitor developments in this area.

[7] In particular comments are requested regarding: (i) application of Code section 512(a)(6) to tax-exempt organizations with more than one unrelated trade or business, including the general interim rule for distinguishing between trades and businesses under Code section 512(a)(6); (ii) whether other Code sections (and the regulations thereunder) may provide an administrable model for identifying a tax-exempt organization's separate trades or businesses; (iii) whether NAICS six-digit (or fewer) codes might be the basis of a method for identifying separate trades or businesses; (iv) the general rules for allocating deductions between trades or businesses; (v) the treatment of income treated as an item of gross income from an unrelated trade or business, including the treatment of debt-financed income (Code sections 512(b)(4), (13) and (17)); (vi) the scope of the activities that should be included in the category of "investment activities;" (vii) the treatment of income derived from activities in the nature of an investment through partnerships; (viii) any additional considerations that should be given to how Code section 512(a)(6) applies within the context of Code section 512(a)(3) for specific types of tax-exempt organizations; and (ix) the calculation and ordering of pre-2018 and post-2017 net operating losses and the treatment of pre-2018 net operating losses that will expire in a given tax year if not taken before post-2017 net operating losses.

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